CLAWBACK FINAL REGULATIONS

Hodgson Russ Trusts & Estates Alert
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On November 22, 2019, the Treasury Department and the IRS issued final regulations regarding the enhanced gift tax exclusion amount that came into effect under the Tax Cuts and Jobs Act (TCJA). Specifically, T.D. 9884 finalized proposed regulations that address how estates will be taxed in the event that an individual makes large gifts which are within the current enhanced gift tax exclusion, but then passes away at a time when the estate tax exclusion has decreased below current levels.

The TCJA increased the gift and estate tax exclusion amount from $5 million per person to $10 million (with both amounts adjusted annually for inflation) for gifts made and for estates of decedents dying after December 31, 2017 and before January 1, 2026. The exclusion amount is how much an individual is permitted to transfer without being subject to federal gift or estate tax (both taxes have a maximum tax rate of 40%). The exclusion amount is unified, meaning that to the extent that taxable gifts are made during life, the gifts reduce dollar-for-dollar the amount of the estate tax exclusion available at death. For 2020, the inflation adjusted exclusion amount is $11,580,000.

The increased exclusion amount is scheduled to sunset on January 1, 2026, at which point it will return to $5 million per person, indexed for inflation. When the TCJA was enacted, many questioned whether a taxpayer who made lifetime gifts within the TCJA's enhanced exclusion amount would be subject to an estate tax on those gifts if the taxpayer died after 2025 when the exclusion amount had sunset. The formula used for calculating the estate tax takes into account the decedent's lifetime gifts. Under the formula, there was a technical concern that gifts made under the larger exclusion could essentially be brought back into the taxpayer's estate and be subject to estate tax at death, an effect referred to as the "clawback."

To illustrate this issue, assume a taxpayer gifts $10 million in 2020. The taxpayer would not owe any gift tax at the time of the gift, because the gift is below the applicable gift tax exclusion amount of $11,580,000. Further assume the taxpayer dies penniless in 2027, when the estate tax exclusion amount is $6 million. Under prior law, the taxpayer's estate would owe estate tax if the sum of (i) prior gifts and (ii) the decedent's assets at death exceeded the then applicable estate tax exclusion amount (that is, prior law would "clawback" the 2020 gift and subject it to estate tax). In this example, the $10 million gift would have been brought back into the taxpayer's estate, with the result that taxpayer's estate would have exceeded the

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estate tax exclusion amount available at death, and estate tax would have been due (although the estate would not have any assets with which to pay the tax).

T.D. 9884 confirms that the IRS will not seek to clawback gifts made while the TCJA's larger exclusion amount is in effect, even if the taxpayer dies after the amount has decreased in 2026. Specifically, the final regulations incorporate a "special rule" in the case of a difference between the exclusion amount applicable to gifts and that applicable at the donor's date of death. This rule permits the taxpayer's estate to compute its estate tax credit using the higher of the exclusion amount applicable to gifts made during life or the exclusion amount applicable on the date of death. As a result, a taxpayer can make large gifts now, without a concern of taxpayer's estate being whipsawed if the gift and estate tax exclusion actually sunsets in 2026.

For more information about the impact of the final regulations, and planning for lifetime gifting and estate planning, please contact a member of our Trusts and Estates team.